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No. 93-404

In The

# Supreme Court of the United States

**October Term, 1994**

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN
and FRANCIS I. BUTLER,

*Petitioners,*

v.

ALLOYD CO., INC. and
WIND POINT PARTNERS II, L.P.,

*Respondents.*

**On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit**

## REPLY BRIEF

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## INTRODUCTION

The primary purpose of the Securities Act of 1933, 15 U.S.C. §§ 77a-zzz (1994) [hereinafter the "Act"] was to regulate public offerings of securities without undue interference with private business. The civil liability provisions of the Act, which make a seller of securities a fiduciary, are justified only in that context.

> "Their essential characteristic consists of a requirement that all those responsible for statements **upon the face of which the public is solicited to invest its money** shall be held to standards like those imposed by law on a fiduciary."

H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933) [hereinafter the "House Report"] (emphasis added). Such fiduciary liability is imposed by Section 12 when a seller makes a public offering but (i) fails to comply with the Act's registration requirements or (ii) sells such securities "by means of a prospectus or oral communication" which includes a misstatement or omission. 15 U.S.C. § 77l (1994). As to either violation, a buyer need not show reliance and is allowed recision as a remedy irrespective of the damages actually caused by the violation. As to unintentional misstatements or omissions, a seller can avoid liability only by sustaining the burden of proving he could not have discovered the truth in the exercise of reasonable care. *Id.* In sum, Section 12 makes a seller a fiduciary of a buyer of securities.

Treatment of one selling to the public as a fiduciary is fair but such treatment makes no sense in the context of private negotiated transactions among parties able to fend for themselves. For this reason, "[t]he committee emphasizes that these liabilities attach **only** when there has been an untrue statement of material fact or an omission to state a material fact **in the registration statement or the prospectus – the basic information on which the public is solicited**." House Report at 9 (emphasis added).

That the Act does not make a seller in a negotiated private transaction a fiduciary is demonstrated by Section 12(2)'s use of the phrase "offers or sells a security . . . by means of a prospectus or oral communication" which must, particularly considered in light of the purpose of the Act and the context of the phrase in Section 12, be read to impose this new federal liability only on those who sell securities to the public.

Despite Buyers' suggestion to the contrary, Sellers do contend that Section 12(2) does not apply to ordinary aftermarket trading transactions as the court held in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d. 682 (CA3), *cert. denied*, 112 S.Ct. 79 (1991). That holding and the arguments of the Securities Industry Association ("SIA") are consistent with and complement Sellers' contention that the Section was never intended to cover private transactions. This Court need only decide here, however, that secondary transactions that bear no resemblance to an initial offering are not covered by Section 12(2) or that a negotiated private stock purchase agreement is not a prospectus within the meaning of Section 12(2).

A decision that Section 12(2) applies in all contexts to "the full array of communications used to sell securities" (Resp. Br. at 14) will affect dramatically the ability of parties to negotiate desired private agreements. It would also make all sellers of securities in millions of ordinary aftermarket transactions fiduciaries of those to whom they sell. Confirming that the Section, like the other civil remedies of the Act, only makes a seller a fiduciary in the context of public offerings will facilitate ordinary aftermarket trading and allow private parties able to fend for themselves to negotiate their transactions without either party being treated as a fiduciary of the other. This is reasonable and proper because all such private parties have ample protection through their contractual rights, their rights under state law and the antifraud provisions of Rule 10b-5. 17 C.F.R. § 240.10b-5, (1992) [hereinafter "Rule 10b-5"].



## SUPPLEMENTAL STATEMENT OF THE CASE

Buyers make many immaterial, and sometimes misleading, factual claims, largely by citing to inferences the magistrate observed *might* be made in Buyers' favor which she believed required denial of Sellers' Motion for Summary Judgment. The District Court has not accepted or rejected the Magistrate's recommendation. Sellers deny many of Buyers' factual allegations and submit that no misstatement was made even if there was an inventory shortfall (which Sellers deny and which cannot now be determined since no interim inventory was taken), because Buyers *knew* that Alloyd's inventory was estimated and would be adjusted – possibly materially; the ultimate adjustment was immaterial because Buyers were compensated for it pursuant to the price adjustment provision in the Agreement; Buyers knew *all* material information about Alloyd since McLean and Butler reinvested in and were officers of Buyer; and Buyers' effort to rescind is due to changed market conditions – not any misstatements by Sellers. A review of the Magistrate's recommendation does, however, demonstrate the unfair evidentiary burden which should not be imposed on a seller in a negotiated private transaction.

What happened here is clear. Dissatisfied in retrospect with their deal, Buyers seek to invoke the Act's anti-waiver provision (15 U.S.C. § 77n) and rescind their purchase based on claimed inadvertent misstatements by Sellers in the very contract Buyers seek to otherwise ignore. They base their claim on their strained interpretation of oral comments even though the Agreement provided that its representations "supersede any prior understandings, agreements or representations by or between the parties, written or oral" (JA 160). They seek recision even though their contract stated that Buyer "expressly waives any and all rights it may have to seek the remedy of recision against Sellers" (JA 149).

Buyers claim an innocent misstatement – not fraud. The unfairness of making Sellers a fiduciary of Buyers in

this private transaction is clear. Also clear is the unfairness of allowing Buyers to rescind their purchase irrespective of the damage – if any – they actually suffered. Such unfairness is perhaps the best indication that Section 12(2), like the other civil liability provisions of the Act, was limited to public offerings and never intended to make sellers fiduciaries in negotiated private transactions among parties able to fend for themselves.

## SUMMARY OF REPLY

The following key contentions of the Briefs of Sellers and the SIA demonstrate separately, and certainly in the aggregate, that Section 12(2) does not extend to this negotiated private transaction:

– the primary purpose of the Act was to regulate public offerings of securities while interfering as little as possible with regular business;

– legislative history confirms that all of the Act's civil liability provisions applied only in the context of public offerings and there is no legislative history to the contrary;

– "offers or sells . . . by means of a prospectus or oral communication" is a limiting phrase demonstrating, as compared to the language of Section 17(a) or the obvious alternative "by means of any communication", that Section 12(2) was only applicable in the context of public offerings;

– the context of Section 12(2) – together with the public offering remedies of Sections 11 and 12(1) – confirm that the remedy applied only in the context of public offerings;

– since the Act, including Section 12(2), did not apply to private transactions there was no need to "exempt" such transactions from Section 12(2)'s coverage; and



– making a seller in a negotiated private transaction a fiduciary of the buyer makes no sense given the total scheme of the Act and would reflect very poor public policy.

## ARGUMENT

### A. THE PURPOSE AND STRUCTURE OF THE ACT SHOW THAT ITS CIVIL LIABILITY PROVISIONS ONLY APPLY IN THE CONTEXT OF PUBLIC OFFERINGS

"Public offerings" as distinguished from "private offerings" defined the exact scope of what the drafters wanted the Act to cover since private offerings were "not a matter of concern to the federal government." J. Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 37 (1959). The bill "carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote." House Report at 5 (emphasis added).[1]

The issue here is whether Section 12(2) represents a significant departure from the Act's limited application by making a seller of securities a fiduciary of the buyer in all contexts. If so, it is simply inconceivable that the legislative history related to the Act in general or Section 12(2) in particular would be totally silent as to that intent. If, however, the Section merely complemented Sections 11 and 12(1) and all were limited in their application to the

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[1] The desire of Buyers and the SEC to avoid consideration of legislative history is understandable in light of its powerful showing that the civil remedies in the Act applied only in the context of public offerings and their inability to show *any* legislative history to the contrary. The legislative history should be given proper weight here, and certainly much more weight than the attempts, particularly by the SEC, to demonstrate intent of the Act by reference to statements in the popular press and unauthenticated comments in unpublished materials.

context of public offerings, the lack of discussion of Section 12(2) makes perfect sense.[2]

The registration and prospectus delivery requirements are the heart of the Act, serving in tandem to assure broad and accurate dissemination of information in public offerings. *See Pinter v. Dahl*, 486 U.S. 622, 638 (1988); E. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1, 9 (1992) [hereinafter "Weiss"]. The *only* detailed explanation of the role and purpose of the Act's civil liability provisions was in the House Report, which makes clear their application only in the context of public offerings:

> Sections 11 and 12 create and define the civil liabilities imposed by the act and the machinery for their enforcement which renders them practically valuable. Fundamentally, these sections entitle the buyer of securities **sold upon a registration statement including an untrue statement or omission of material fact**, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated **in such distribution** either knowing of such untrue statement or omission or having failed to take due care in discovering it. The duty of care to discover varies in its demands upon **participants in securities distribution** with the importance of their place **in the scheme of distribution** and with the degree of protection that **the public** has a right to expect.

*Id.* at 9 (emphasis added). All of the articulated justifications for the fiduciary remedy of Section 12 were based on the reasonableness and fairness of imposing fiduciary

[2] Buyers assert that Seller's construction of Section 12(2) creates a significant "gap" in the remedial structure of the Act by limiting the class of buyers covered by the Act. (Resp. Br. at 28) This is a *non sequitur* because the Act's other civil remedies plainly apply only in the public offering context, thus affording relief only to a select group of buyers – *buyers in a public offering*.



liability on those soliciting the public to invest. Making sellers engaged in public offerings fiduciaries of buyers and imposing a recision remedy irrespective of damage actually caused by a misrepresentation were appropriate because the common law "was not consciously molded for the *flotation* of securities." H. Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933) [hereinafter "Shulman"] (emphasis added). Excusing buyers from showing "reliance" on misstatements in public offerings was reasonable since such misstatements, "because of their wide dissemination, determine the market price of the security." House Report at 10. Imposing the burden of proof of exercise of reasonable care was plainly fair as to "those who purport to issue statements *for the public's reliance*." *Id.* at 9. Finally, no unfair burden was imposed by Section 12 since, in the context of a public offering, avoidance of liability under the Section was not difficult. "Once it is determined that registration and prospectus are necessary, it cannot be unduly difficult to ascertain whether a registration statement is in effect and what prospectus satisfies the requirements of Section 10." Shulman at 243.

Section 12, since perceived to be applicable only in the context of public offerings, did not invoke much criticism. *Id.* at 242. Such lack of criticism simply cannot be squared with any notion that Section 12(2) made all sellers of securities fiduciaries in all contexts. Such a new federal remedy in purely private or intrastate contexts would have raised constitutional uncertainties as well as opposition on the ground that it represented an unwarranted intrusion of the federal government into private and intrastate business affairs. The House Report at 10 noted that to impose responsibility beyond those who purport to issue statements *for the public's* reliance "apart from constitutional doubts, would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public." The House Report also specifically referenced the constitutional rationale for the liability provisions of the bill, stating:

> The constitutionality of the imposition of liabilities of the character provided by the bill raises no serious concerns. Even though the activities of the particular persons concerned may be actually intrastate in character, they are, nonetheless, *an integral part of a process calling for the interstate distribution of securities.*[3]

*Id.* at 10 (emphasis added). There would plainly have been significant criticism if Section 12(2) had been perceived as broader than the rest of the Act and applicable to all communications in all contexts, even private and intrastate transactions. The lack of such criticism of Section 12(2) is certainly telling as to the perceived scope of the coverage of the Section.

Equally telling were the criticisms that the Act's coverage should have extended to transactions involving "old stock". SIA Br. at 15-17. Not one of the Act's proponents responded that Section 12(2) made a seller a fiduciary in such transactions. Rather, the response was to explain the bill's exclusive focus on initial public offerings and its inapplicability to the secondary market – regulation of which was a matter "left for subsequent and much-needed legislation." Comments of Sen. Norbeck, 77 Cong. Rec. 3223 (1933).[4] Such criticisms and responses plainly show that the remedy of Section 12(2) was not believed to apply in any context other than public offerings.

H.R. 5480, 73d Cong. 1st. Sess. (1933) [hereinafter "House Bill"] was the bill that formed the basis for the

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[3] *See also* comments of Rep. Cox ("A prospectus is not a thing of value, it is not even intercourse, and therefore is not in commerce, and not subject to the control of Congress.") 77 Cong. Rec. 2938. *See generally* Isaacs, *The Securities Act and the Constitution* 43 Yale L.J. 218 (1933).

[4] The observation of Buyers and the SEC that Rule 10b-5 was adopted much later misses the point of Sellers' argument which is simply that the declared intent of Congress to regulate aftermarket activity in a later act shows its understanding that such regulation had not already occurred by virtue of Section 12(2).



Act. *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 590 (CA7 1993), *cert. granted*, 114 S.Ct. 907, *cert. dismissed*, 114 S.Ct. 1146 (1994) acknowledges that: "Based on the House Report, the legislative history of the 1933 Act can be read to focus on those offerings requiring a registration statement, or as the Third Circuit interprets, to initial offerings." The SEC properly acknowledges that the first House bill and its Senate counterpart "expressly provided that the remedy for securities purchasers based on misrepresentations *was not applicable in private or aftermarket transactions*." SEC Br. at 15, n. 16 (emphasis added). The SEC claims this original limited coverage was expanded dramatically in the final Act but fails to identify effectively any change or comments reflecting the expansion.[5] There were none because the claimed expansion never occurred.

Buyers, in conflict with the SEC, contend the original Senate bill, S. 875, 73d. Cong., 1st Sess. (1933) [hereinafter "Senate Bill"] covered private transactions by citing only Section 9 of that bill and ignoring the bill's Section 12(c) which exempted private transactions from the entire bill. *Pacific Dunlop* reached the same erroneous conclusion noting Section 12(c) but failing to recognize the breadth of its scope.[6] Buyers and *Pacific Dunlop* support their

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[5] In support of this assertion, the SEC references only (a) movement of the remedy from Section 11 to Section 12 but the latter Section was as clearly applicable to public offerings as the former; and (b) the narrowing of Section 4's exemptions to make them exemptions only from Section 5. This, however, begs the question of whether Section 12(2) applies to the exempted transactions in the first place.

[6] Section 12(c) of the Senate Bill provided: "Except as hereinafter otherwise expressly provided, the provisions *of this Act* shall not apply to . . . Isolated transactions. . . ." H.R. 5480 as passed by Senate, § 12. No subsequent provision of the Senate bill provided that the "isolated transaction" exemption should not apply to Section 9. Treating Section 9 as itself so providing, as the Seventh Circuit appeared to do, clearly would be error, since Section 9 appears *before* Section 12 and in any event does not "expressly provide" that it applies to "isolated transactions".

respective positions by reference to the Conference Committee Report. H. Rep. No. 152, 73d Cong., 1st Sess. (1933) [hereinafter "Conference Committee Report"]. Resp. Br. at 35-37; *Pacific Dunlop* at 591-92. Both references are erroneous and it is noteworthy that the SEC does not join in either of their arguments. *See* SEC Br. at 15.

The treatment by the Conference Committee can only be understood by considering the differences in the bills the Committee addressed. The Senate Bill contained a broad civil liability provision (Section 9) applicable on its face to all sales of securities but by Sections 11 and 12 exempted *from the entire bill* various securities and private and aftermarket transactions. The House Bill exempted certain securities *from the entire bill* but by Section 12(2) provided specifically that Section 12(2) applied to the exempt securities. The House Bill also contained narrower civil liability provisions (identical in all material respects to Sections 11 and 12 as finally adopted) applicable only to public offerings (as evidenced by Section 13 of the House Bill which prohibited actions under Sections 11 and 12 more than ten years after the securities were "offered to the public").[7]

Because neither bill contained civil liability provisions applicable to private or aftermarket transactions, the bills had "substantially similar provisions" in that respect as the Committee noted. The only material difference between the Bills' respective liability provisions

[7] Buyers cite Section 13's *amended* version which uses "offered to the public" in reference to claims under Section 12(1) and "after the sale" in reference to claims under Section 12(2) as evidencing broader coverage by Section 12(2). Resp. Br. at 26 n.18. The reference does not help Buyers. Section 12(1) is violated by the failure to register a public offering and the commencement date of the offer is the reference point. As to Section 12(2) the violative conduct occurs when a misleading prospectus is delivered which might be significantly later than the initial public offering. Plainly, it makes sense to use the sale date as the reference point as to such claims. The amendment was nothing more than a clarification and did not create new coverage where none existed previously.



concerned whether sellers would be liable for misstatements in public offerings of exempt securities.[8] The Committee noted *this difference* (in treatment of exempt securities) as the only significant difference between the otherwise "substantially similar provisions" of the bills and the House Bill's application of Section 12(2) to public offerings of such securities was confirmed, except that "government securities" were excluded. Conference Committee Report at 26-27.

The court in *Pacific Dunlop* and Buyers incorrectly construe the Committee's reference to "the substantially similar provisions" as confirming that the Committee equated the liability provisions in the two bills construing both as applicable to "private transactions." *Pacific Dunlop* at 591, Resp. Br. at 36-37.

In sum, Buyers, the SEC and *Pacific Dunlop* argue, in conflicting manners, that although the language remained the same, the coverage of Section 12(2) evolved from "public offerings" to "all transactions" as the Act was adopted. *Nothing*, however, in the language, language changes or legislative history of the Act suggests such an evolution. It simply defies belief that such a fundamental change was made intentionally but without comment.

[8] The Conference Committee's decision to subject sellers of securities exempted from registration by Section 3 of the Act, 15 U.S.C. § 77c, to Section 12(2) liability does not change the conclusion that Congress intended Section 12(2) to apply only to public offerings. The types of securities covered under Section 3 either already faced some form of outside regulation or possessed diminished potential for fraud. Still, if the distribution of such securities is a public offering Section 12(2) would apply to protect the public.

### B. THE LANGUAGE OF SECTION 12(2) SHOWS THAT IT ONLY APPLIES TO PUBLIC OFFERINGS

The *Ballay* court analyzed Sections 12(2) and 2(10) of the Act and concluded "that Congress employed the term 'prospectus' as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." *Ballay* at 688.

The interpretation of Section 12(2) advanced by Buyers and the SEC depends almost entirely on what they contend is the "plain meaning" of Sections 12(2) and 2(10) 15 U.S.C. § 77b(10). Considering *only* the language used in Section 12, however, it is more reasonable than not to conclude that Section 12(2) applies only to public offerings, as does Section 12(1) which it follows and with which it shares common language defining who is liable, who can sue, and the remedy provided. In addition, to read "by means of a prospectus or oral communication" as anything other than a phrase of limitation would strip it of all meaning.[9] Had Congress intended Section 12(2) to apply to all sales of securities, it would have made that section applicable to any person who "offers or sells a security . . . by means of any untrue statement of a material fact or any omission to state a material fact necessary. . . . " *Compare* Section 17(a). Congress' failure

[9] Respondents' Brief does not even attempt to respond to this compelling observation and the SEC's response is merely that "The Securities Act is characterized by the use of phrases intended to denote breadth and emphasis, even if a briefer formulation might have been available." SEC Br. at 9-10. This assertion, however, begs the question by assuming – without basis – that Congress intended such "breadth" rather than "limitation." Equally weak is the SEC's claim that use of "prospectus or oral communication" was "a useful way to underscore that Congress intended to cover not just written communications, but also broadcasts and oral statements." SEC Br. at 9. It would have been much more enlightening and clarifying and thus "useful" for Congress to have simply said "any communications" or "any written or oral communications" if that is what was really intended.



to adopt that broader and more straightforward language must be honored. *See Reves v. Ernst & Young*, 113 S.Ct. 1163, 1169 (1993). Finally, "by means of a prospectus" must refer to sales by means of the sort of document – a "prospectus" – that typically is used when securities are sold to the public.[10]

The "plain meaning" of Section 12(2), if read in isolation, is that it applies only to public offerings of securities. With that meaning, it becomes clear how Section 12(2)'s remedy is properly applied in the context of public sales of securities otherwise exempt from the Act.

Buyers and the SEC argue that Section 12(2) must be read in light of the language of Section 2(10), which defines "prospectus". However, they misread Section 2(10) which in 1933 defined prospectus as meaning "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio, *which offers* any security for sale." (emphasis added). These words can only be regarded as limiting the universe of communications being referenced.[11] While the words "letter, or communication" in Section 2(10) are more generic in scope, their placement in Section 2(10) can only be deemed to refer to

[10] Such a construction is, as discussed above, shown by the initial version of Section 13 and also shown by the very early releases of the FTC regarding effective dates for application of various sections of the Act. The June 2, 1933 Release speaks in terms of Section 12(2)'s application to "outstanding securities as well as to new issues which are to be *placed on the market* after registration." *Effective Dates of Securities Act of 1933 Are Explained*, Securities Act of 1933, Rel. No. 3, 1933 SEC LEXIS 8 at 2 (June 2, 1933).

[11] Significantly, the list does not include the very type of document primarily at issue here, namely a contract or agreement. All sales occur by means of some form of oral or written contract or agreement. It is inconceivable that Congress would not have included those words in the list if Congress really intended that prospectus have the broad meaning Buyers ascribe to the word.

letters or communications akin to an advertisement.[12] To construe these terms otherwise renders all the words preceding them in Section 2(10) mere surplusage – clearly an improper construction. *See Reves v. Ernst & Young*, 113 S.Ct. 1163, 1169 (1993).

The words used in Section 2(10) refer only to communications used to solicit the public. If Section 2(10)'s list of terms defining "prospectus" was meant to have the breadth claimed by Buyers, Congress would have simply define "prospectus" as "any communication which offers a security." The language and structure of Section 2(10) demonstrate that its listing of the communications that can constitute a "prospectus" is limited to communications that, like a prospectus, offer securities to the public. A privately negotiated contract of sale, the alleged "prospectus" in the instant case, does not fall within that definition.

Buyers and the SEC also fail to give proper consideration to the "context" clause of Section 2(10). The SEC acknowledges that in some contexts a "prospectus" does not mean "any communication." SEC Br. at 10. It claims that Section 12(2) is not such a context but does not explain why. The only "authority" the SEC really quotes setting forth any explicit claim as to the scope of coverage intended by Section 12(2) are lobbyist groups' alarmist articulations as to the feared breadth of a provision. This "authority" is entitled to no weight whatsoever. The failure to affirmatively legislate in response to the alarmist concern means nothing if the concern was misplaced in the first place.

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[12] Securities Act of 1933, Rel. No. 54 1933 SEC LEXIS 59 at 2 (Oct. 13, 1933) spoke in terms of Section 12(2) applying to securities being "advertised" stating that old securities could be "*advertised in any form*, subject only to the limitations of Sections 12(2) and 17 imposing civil and criminal liability for material misstatements and omissions." By its very use of "advertised" – as opposed to "sold" – the SEC was implicitly construing "prospectus" as Sellers assert the term was intended to be construed.



Buyers and the SEC argue, in essence, that while Section 12(2) should not itself be read in isolation, it is nonetheless appropriate to read Sections 12(2) and 2(10) collectively in isolation from the other sections of the Act. Section 2(10) *must*, as its "context clause" anticipates, be read in relation to the other provisions of the Act, most notably Section 5, 15 U.S.C. § 77e. To ensure the effectiveness of Section 5(b)(1)'s prohibition of dissemination of any written selling materials to prospective purchasers in a *public* offering prior to delivery of a final prospectus, Section 2(10) defines as a "prospectus" any written communication or broadcast selling materials sent to a prospective purchaser.[13] Nothing in the Act supports the view that Congress intended to bring within its definition of "prospectus" communications that offered a security for sale in other contexts. Similarly, nothing in the language of Sections 2(10) or 12(2) supports the view that Congress intended to treat communications that do not relate to a public offering as a "prospectus," for purposes of Section 12(2).

In fact, it is clear that the Section 2(10) definition of "prospectus" *cannot* be imported wholly into Section 12(2). The second part of Section 2(10) excludes from its definition of "prospectus" written selling materials (or a confirmation) that a seller delivers to a prospective purchaser after the seller has delivered a statutory prospectus. Even though Section 2(10) provides that such materials are *not* a prospectus, Section 12(2) clearly applies to misstatements in such materials. House Report at 13. While the portion of Section 2(10) excluding such materials from the definition makes sense after the information requirements of Section 5 are satisfied, it does not

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[13] Buyers claim SEC Rel. No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941) shows that the SEC has consistently interpreted "prospectus" to include a broad range of written selling communications. (Resp. Br. at 23) In fact, however, the release discusses the term "prospectus" solely in relation to Section 5's prohibition on dissemination of written selling materials prior to delivery of a statutory prospectus.

make sense in the context of Section 12(2), strongly suggesting that Congress intended the Section 2(10) definition to apply in the context of Section 5, not Section 12(2). Weiss, at 14-16.

Finally, it is important to consider Section 12(2) in the context of the 1933 Act as a whole. Buyers assert, but without citation to any authority beyond their "plain meaning" argument, that Section 12(2) "creates an expansive civil remedy for misrepresentations made by [all] sellers of securities." (Resp. Br. at 9)[14] Section 12(2) is more accurately described as complementing Sections 11 and 12(1) by imposing civil liability in public offerings on those who cannot be reached under those liability provisions. Interpreting Section 12(2) as proposed by Sellers will not strip it of meaning or function; rather, it will confine Section 12(2) to its proper and intended sphere.

In sum, the language of Section 12(2), whether viewed in isolation or in the context of all other relevant sections of the Act, indicates that Section 12(2) only creates a remedy in connection with public offerings of securities. Plainly, this reading is supported by a great deal of authoritative legislative history, while no such support exists for Buyers' interpretation of Section 12(2).

### C. WELL CONSIDERED – PRECEDENT AGREES THAT SECTION 12(2) ONLY APPLIES TO PUBLIC OFFERINGS

Since *Ballay*, most of the courts considering this issue have concluded that Section 12(2)'s application was

[14] Buyers misleadingly cite *Westinghouse Elec. Co. v. "21" Int'l Holdings, Inc.*, 821 F. Supp. 212 (S.D.N.Y. 1993), as demonstrating that private sales of securities are sometimes registered. The transaction there had to be registered because of the purchaser's intent to resell the stock.



intended to be limited to the public offering context.[15] Buyers, and to lesser extent the SEC, nonetheless attempt to rely on old precedent reflecting an initial and erroneous assumption regarding the language and intent of Section 12(2) which was uncritically adopted by later commentators and courts.

*Moore v. Gorman*, 75 F. Supp. 453 (S.D.N.Y. 1948), was the first court to analyze whether Section 12(2) applied to exempt transactions. The court begged the essential question when it concluded that Section 12(2) applied even to exempt transactions because Section 4 "does not purport to, nor does it, confer any exemption from the civil liability imposed by Section 12(2)." *Id.* at 456. Of course, that Section 4 does not purport to exempt private offerings from Section 12(2) would be significant *only if* Section 12(2) otherwise applied to exempt transactions.[16] The precedential value of the *Moore* decision is further weakened by the fact that the transaction in *Moore* was probably not exempt and thus should have been registered. *See, e.g., United States v. Wolfson*, 405 F.2d 779 (CA2 1968), *cert. denied*, 394 U.S. 946 (1969).

[15] *See First Union Discount Brokerage Serv., Inc. v. Milos*, 997 F.2d 835 (CA11 1993); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, 1989 CCH ¶ 94,391 (E.D.N.C. 1989), *cert. denied*, Fed. Sec. L. Rep. ¶ 94,564 (E.D.N.C. 1989); *Fujisawa Pharmaceutical Co. v. Kapoor*, 814 F. Supp 720, 728 (N.D. Ill. 1993); *Budget Rent A Car Systems, Inc. v. Hirsch*, 810 F. Supp. 1253, 1257 (S.D. Fla. 1992).

[16] "[T]o conclude that Section 12(2) applies to private offerings *because* Section 4 does not exempt such offerings from Section 12(2) makes no more sense than to say that Section 11 applies to private offerings because Section 4 does not exempt such offerings from Section 11." Weiss at 27. No one would dispute that Section 11 applies only to a transaction that involves use of a registration statement and, similarly, no one can dispute that Section 12(2) applies only to a transaction effectuated "by means of a prospectus or oral communication." Whether a privately negotiated sale is such a transaction was the question of first impression before *Moore*. The *Moore* court's failure to address – much less answer – *that* question led it and later courts astray.

*Moore* was cited by Professor Loss in the first edition of his influential treatise, *Securities Regulation*, 997 (1951) [hereinafter "Loss"] where, without analyzing the nature of the remedy or what the phrase "by means of a prospectus or oral communication" means in Section 12(2) he asserted: "[T]he Section applies to all sales of securities, whether or not registered, whether or not the particular security or transaction is exempted from Section 5". Professor Loss attributed the absence of an express statement that Section 12(2) applied to transactions exempted by Section 4 to "a mere happenstance of drafting." *Id.* n. 201.

*Wilko v. Swan*, 127 F. Supp. 55, 58 (SDNY 1955) added momentum to this erroneous view when it asserted, without analysis of the language or intended coverage of Section 12(2), that the Section expressly rendered inapplicable the exemptions of sections 3 and 4 of the Act. *Woodward v. Wright*, 266 F.2d 108 (CA10 1959), which held that Section 12(2) applied to a private sale, cited *Wilko* uncritically and asserted, without further analysis, that Sections 12(2) and 17 of the 1933 Act "grant recision or damages for fraud or misrepresentation in the sale of the securities generally."

The later decisions cited by Buyers illustrate the widespread influence of these early misguided authorities. First, *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695 (CA5 1971) assumed as a "preliminary observation" that Sections 3 and 4 do not expressly exempt private transactions from Section 12(2), citing, without analysis, *Woodward*, *Moore* and Loss. Then *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (CA5 1973), *cert. denied*, 415 U.S. 977 (1974), in *dicta* since public offers were made, cited *Hill* without analysis. Next, *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) merely cited *Nor-Tex*. Finally, *Multimedia Co. v. Fugazy*, 983 F.2d 350 (CA2 1992), *cert. denied*, 113 S.Ct. 2445 (1993) relied on *Hill York*, *Nor-Tex* and Loss and did not independently analyze the issue.

As Professor Loss observes in *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992):



> "Every so often a faulty decision by one court is picked up by a second, and then by a few more, until it acquires a life of its own. In the fullness of time, however, a few brave judicial souls see the light . . . and further development is set on the right course."

Until *Ballay* focused attention on the intended coverage of Section 12(2), the notion that it covered all transactions had achieved a "life of its own" not based on any analysis of Section 12(2)'s language or purpose. The Court here can set further development on the right course by approving the reasoning of *Ballay* and other recent cases holding that Section 12(2) does not apply to negotiated private transactions.[17]

## CONCLUSION

Making a seller of a security a fiduciary makes no sense whatsoever in a private negotiation context where parties able to fend for themselves are attempting to strike the best deal. Such parties should be able to negotiate risk bearing or sharing without the seller being forced to be the guarantor of the accuracy of all disclosures and the lack of materiality of all omissions. Fraud is what is

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[17] Buyers' references to prior statements by this Court, frequently out of context or in phrases never intended to have the meaning Buyers now ascribe to them, are not persuasive. This Court has never focused on the issue now before it and the pretense of Buyers to the contrary must be rejected. In particular, *Gould v. Ruefenacht*, 471 U.S. 701, 703-704 (1985), while it involved a claim under Section 12(2) relied on the analysis in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) which contributed nothing to aid the analysis of Section 12(2) since the Court there held only that the stock involved was a "security" within the meaning of the Securities and Exchange Act of 1934, specifically referencing the lack of exemption in that Act comparable to those in Section 4 of the 1933 Act. Sellers' assertions here as to the meaning of "by means of a prospectus" is in no sense analogous to an argument that a block of stock is not a security within the meaning of the Acts.

actionable in private contexts – not innocent misstatements or omissions. The conclusion of the Court here must be that Congress did not intend, by the Act, to make sellers of securities in negotiated private transactions fiduciaries of the buyers.

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